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SUBJECT: SOUTH AFRICAN MONETARY AUTHORITIES EXPECT INFLATION
WITHIN TARGET RANGE ALTHOUGH RISKS REMAIN

¶1. Summary. At the May 11th semiannual Monetary Policy Forum meeting, officials from the South African Reserve Bank (SARB) briefed members of the economic community on the justification of leaving interest rates unchanged so far in ¶2006. Citing lowered inflation expectations since November 2005 and inflation having been within the 3%-6% target range for the past 31 consecutive months, the SARB expects inflation to remain within its target range over the next several years. However, risks to inflation remain the same. Increasing current account deficits, rising oil prices, strong consumer demand and increasing household debt levels still worry the SARB as potential harbingers of accelerating inflation. Recent statements by the SARB Governor Mboweni and Finance Minister Manuel suggest that future SARB action may lean towards interest rate increases to curb inflationary risks. The SARB also presented research that suggested South Africa's current growth potential (non-inflationary growth) was slower than what would occur if government's economic targets were met or if South Africa attained the average competitive performance of emerging markets. End Summary.

So far, Inflation Under Control

¶2. Targeted inflation, i.e., consumer prices without mortgage costs, has remained within the 3%-6% range for the past 31 consecutive months. Since the last Monetary Policy Forum in November, inflationary expectations have steadily declined, and thus the SARB has steadily lowered its forecasted peak inflation rate over the next two years. In October 2005, SARB thought inflation would peak at 5.8%; its current inflation peak is 4.9% occurring in the first quarter 2007, and then receding to just over 4.5% throughout ¶2008.

South Africa Faces Same Inflationary Risks Over Past Year

¶3. The inflationary risks facing South Africa have not changed over the past year. High and volatile oil prices, widening current account deficits, strong consumer demand and increasing household debt levels have provided SARB with enough reasons to be cautionary about rising inflation in the future. So far, none of these risks have translated into substantially higher inflation.

¶4. The relative strength of the rand has tamed the impact of rising oil prices denominated into dollars. Little

evidence exists to suggest rising oil prices are causing increased secondary inflation. The strong rand did encourage cheaper imports, with imports increasing by 10.1% in 2005 compared with export growth of 6.7%. However, cheaper imports provide more competition to domestically produced goods and limit possible price increases.

¶5. Rising disposable income along with relatively low interest rates mean that increased debt is still relatively affordable. Even though household debt reached 65.5% of disposable income during the last quarter 2005, debt service costs are 7% of disposable income, less than half the 1998 level.

Jawboning Attempts to Reduce Inflationary Risks

¶6. Recent statements by both SARB Governor Mboweni and Finance Minister Manuel on the dangers of incurring additional debt in the face of possible interest rate hikes underscore the importance of moral suasion in trying to cool strong credit and consumer demand. Over the past two years, household consumption growth supported strong growth in GDP, with strong growth in household spending on durable and semi-durable goods.

¶7. SARB's most recent Financial Stability Review (March 2006) warned about recent changes signaling that borrowers might be facing repayment problems. Mortgage loans overdue (those that are more than 180 days overdue and either inadequately secured or uncollectible) increased by 5.5% in the year to February 2006, while the ratio of overdue

mortgage loans to total mortgage advances increased from 1% in the third quarter 2005 to 1.2% in the fourth quarter. Both Mboweni and Manuel have warned about possible impacts of increasing interest rates on consumers, saying what goes down must come up.

Interesting Asides

¶8. For every Monetary Policy Review, the SARB publishes separate sidebars that highlight recent topics of research. This issue featured three topics, one of which generated great discussion and had implications for government policies. The May issue of the MPR featured bank research on household indebtedness, comparing affordability indices across countries; a discussion on global trade imbalances and summary of research on measuring South African potential output. Given the South African government's emphasis on achieving accelerated growth, discussion on potential output raised questions.

¶9. Potential output is the maximum sustainable level of output consistent with stable inflation. It can never be observed, but most econometrically estimated macroeconomic models estimate potential output by using production functions that use total factor productivity, desired capital stock and a natural rate of unemployment (frictional not structural unemployment).

¶10. SARB's research posits four scenarios: status quo, utopia, government targets, and international benchmarks. SARB's discussion does not make it precisely clear which value of the natural unemployment rate each scenario uses. The status quo uses some positive value (not specified). Utopia scenario uses 0, which assumes there is neither structural nor frictional unemployment. Government targets scenario assumes unemployment is halved in 10 years, savings to GDP ratio reaches 22% and the foreign direct investment/GDP ratio reaches 1.3%. International benchmark scenario assumes that South Africa achieves the average performance of emerging markets, where the unemployment rate is 12%, FDI to GDP is 4% and the savings to GDP ratio is

25%.

¶11. The results are illuminating. The status quo scenario yields 4.1% growth in potential output, utopia shows 6.9% growth, the government target scenario's growth of potential output is at 5.1%, and the international benchmark scenario reaches 6.5%.

¶12. Comment. Only the results were presented at the presentation without explanation of the assumptions behind each scenario. Several questions arose concerning the relatively low growth of potential output in both the status quo and government target scenarios. SARB representatives stressed that the analysis was intended as contributions to current research and not serve as the SARB's opinion of South Africa's current growth potential, or what would occur if the government's economic targets were met. End comment.

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